Research Blast

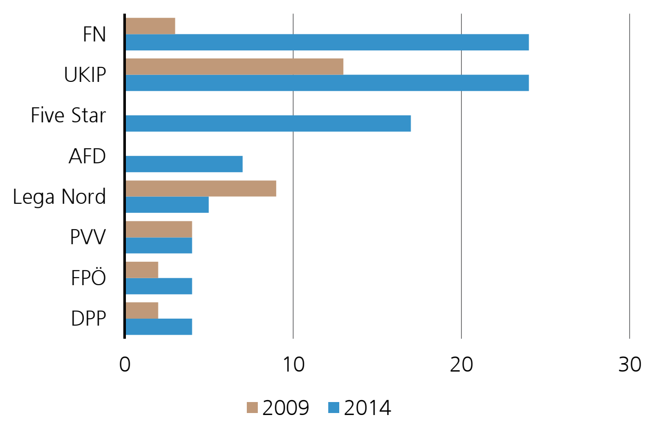
European Real Estate Market, Thoughts and views in the wake of Brexit – July 2016

Real estate and the rise of populism

The end of the end of history

In 1989, Francis Fukuyama proclaimed that we had reached "the end of history" by effectively arguing that the ideological struggles of the twentieth century had been resolved in favor of market liberalism, democracy and international trade. There is now no question that this consensus – if it ever existed – is completely unravelling. The UK's historic vote to leave the EU came as a huge shock to the political establishment but what was more interesting, was the intensity of the post-referendum debate and the deep societal divisions it exposed. This appears to be just the tip of the iceberg as populist parties have gained real momentum in Europe, most of whom increased their representation in the European Parliament significantly between 2009-14 (Figure 1). In southern Europe, disillusioned voters are backing Podemos in Spain, Syriza in Greece and the Five Star movement in Italy. Even in the more prosperous areas of northern Europe, the National Front in France, the AfD in Germany, and the Dutch Freedom Party in the Netherlands have all increased in prominence, while the FPÖ in Austria were a whisker away from winning a general election.

Figure 1: Populist MEPs in European Parliament elections

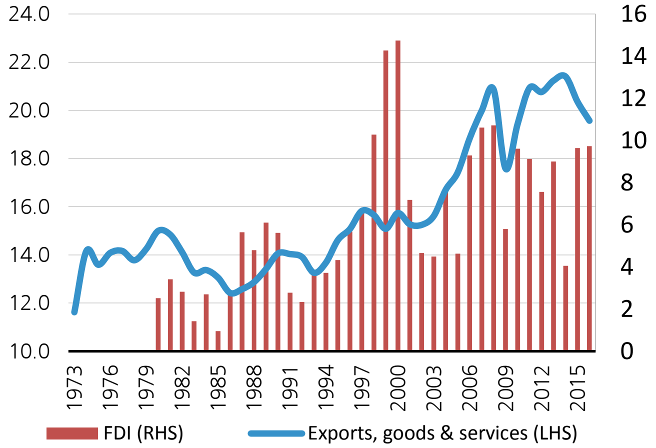


Source: European Parliament, Party websites

Does a rising tide lift ALL boats?

It is difficult to understand hostility to free markets when there are demonstrable economic benefits. Exports of goods and services have been on a steady upward trajectory since the early 1970s and now account for a significant proportion of GDP in most major European economies. The creation of the single market has been an unmitigated success for Europe, particularly Germany which has seen exports rise from 15% of GDP in 1973 to almost 46% in 2016. Most economies have also benefitted from foreign direct investment (FDI) which has increased particularly since the early 2000s when China's accession to the WTO and high oil prices brought new investors from the Middle East and Asia onto the global stage. Cities such as London have been greatly boosted by FDI, particularly direct property investment, which has seen huge capital inflows as well as significant development (principally) in the City and West End. The free movement of trade, capital and knowledge in Europe has thus undoubtedly created jobs, increased productivity, technological innovation and provided consumers with an ever greater choice of affordable products, made possible by outsourced manufacturing and global supply chains. The global real estate sector has developed accordingly and benefited significantly from globalization.

Figure 2: FDI (% of total fixed investment), exports, goods and services (% of GDP)



Source: Oxford Economics. Weighted average of US, Japan, UK, France, Germany, and Italy.

So why are voters embracing populism? The short answer is because the benefits of globalization are not always spread evenly. Low cost manufacturing in emerging markets has given us cheap consumer goods but also led to job losses in mature economies. While world trade growth has been very strong in recent years, GDP per capita has grown much more slowly as have wages and real disposable income. The failure of policymakers to address these issues has created a critical mass of voters attracted by the easy solutions offered by populism.

Consequences for real estate

The impact of populism on property markets is difficult to quantify, though it is likely the macro-consequences will be negative. Populist policies are generally inward looking and may lead to lower growth, higher inflation, higher taxes, and are likely to introduce greater bank regulation, pushing the cost of debt higher. Property, as an illiquid asset class, is more at risk of being targeted with increased taxes; the UK government's introduction of stamp duty on buy-to-let investments is an example of this. The main area where the impact of populist policies is likely to be felt is investment markets. The cross-border flow of capital into UK real estate has increased markedly since 2001 and played a key role in the recovery years following the GFC. Capital coming from outside of Europe has been more significant than intra-regional investment, and it is likely that prospective global investors – who may not have good local market knowledge – will bypass the UK and even Europe in the wake of political uncertainty and reallocate to more (perceived) stable markets such as the US or their respective domestic market. Not only do populist governments make investors wary, they are also inclined to introduce protectionist measures restrictive of investment. If populist parties gain wider influence in Europe, we could see international and intra-regional investment scale back sharply.

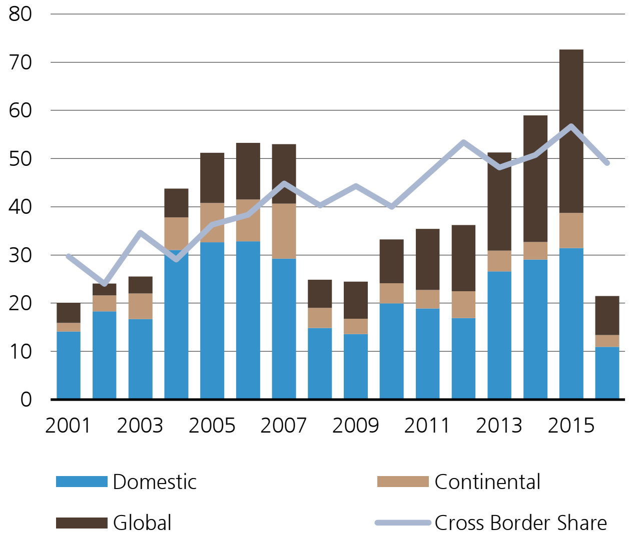
The immediate impact on the occupier markets is also likely to be negative. For logistics, a strong performer in recent years, the possible imposition of tariffs and trade-restrictive measures represents a strong risk. The OECD estimates that for every dollar of tariff protection, two dollars are lost from world trade, which is likely to be a drag on a nascent sector which has attracted high inflows in recent years largely because of its exposure to cross-border trade. The retail sector, especially in tourist centers like London, Paris or Milan is also in danger of losing the flow of international retailers, which both drive rental growth and create a vibrant mix in high streets and retail schemes. Offices are likely to be strongly affected too, as multinational firms will probably find the regulatory landscape far more challenging with the issue of London-based banks passporting rights already in doubt after the referendum. Outside of London, employers make use of regional centers such as Birmingham, to perform back office functions; these could also be moved if the UK leaves the single market. The only potential positive for Real Estate is that assets with inflation-linked leases (such as supermarkets) may benefit from an inflationary environment; however this is very likely to be offset by weakened aggregate demand.

There are now also significant political risks to the property market. The real possibility of government intervention (such as rent controls, introduced in Germany in 2015) could deter investment in the residential sector, particularly build-to-rent which is attracting more institutional interest. Alternative assets such as secondary healthcare (ie. care homes) and student accommodation could also be at risk from political interference.

On an international level, this could be problematic as well. One of the achievements of the EU was fostering mutually beneficial cooperation between countries, which had historically tended towards confrontation. Fragmentation within the EU could reduce this cooperation and ultimately lead to protectionist measures, further suppressing market activity and cross-border flows.

Positively, however, it is unlikely we will see an outright populist government in Europe anytime soon. But the potential for political uncertainties remains; the next upset could come as early as October as a potential "bail-in" of bank bondholders in Italy could coincide with a constitutional referendum, leading to another populist backlash. But for the astute property investor, taking stock of these trends going forward is essential; the world seems to be changing and local market local knowledge will become even more important.

Figure 3: UK total CRE investment (GBP billion)



Source: Real Capital Analytics

Real Estate Research & Strategy

Sean Rymell

For more information please contact:

UBS Asset Management
Global Real Estate Research & Strategy
Sean Rymell
Tel. +44-20-7901 5102
sean.rymell@ubs.com

www.ubs.com/realestate

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